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Company Examinations

**REPORT ON EXAMINATION**

of the

**PREFERRED AUTO INSURANCE COMPANY, INC.**

**MEMPHIS, TN**

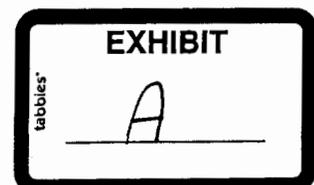
as of

**DECEMBER 31, 2002**

**DEPARTMENT OF COMMERCE AND INSURANCE**

**STATE OF TENNESSEE**

**NASHVILLE, TENNESSEE**



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Memphis, Tennessee  
May 5, 2004

Honorable Paula A. Flowers  
Commissioner  
State of Tennessee  
Department of Commerce and Insurance  
Nashville, Tennessee 37243

Dear Commissioner:

Pursuant to your instructions and in accordance with Tennessee insurance laws, regulations, and resolutions adopted by the National Association of Insurance Commissioners (NAIC), a financial examination and market conduct review was made of the condition and affairs of the

**PREFERRED AUTO INSURANCE COMPANY, INC.**  
**MEMPHIS, TENNESSEE**

hereinafter and generally referred to as the Company, and a report thereon is submitted as follows:

**INTRODUCTION**

This examination was called by the Commissioner of Commerce and Insurance of the State of Tennessee and commenced on June 25, 2003. The examination was conducted under the association plan of the NAIC by duly authorized representatives of "The Department of Commerce and Insurance", State of Tennessee.

**SCOPE OF EXAMINATION**

This examination report covers the period from December 12, 2000, the date of the last previous examination, to the close of business on December 31, 2002, and includes any material transactions and/or events occurring subsequent to the examination date and noted during the course of the examination.

The examination of the financial condition was conducted in accordance with guidelines and procedures contained in the National Association of Insurance Commissioners (NAIC) Examiners Handbook. During the course of examination, assets were verified and valued and liabilities were determined and estimated as of December 31, 2002. The financial condition of the Company and its amount of solvency were thereby established. Test checks were made of income and disbursement items for selected periods, and a general review was made of the

Company's operations, practices, and compliance with applicable statutes and regulations. All asset and liability items contained in the financial statement of this report were examined and verified with relative emphasis according to their amount and potential impact on capital and surplus.

In addition, the following topics were reviewed:

- Company History
- Charter and Bylaws
- Management and Control
- Corporate Records
- Fidelity Bonds and Other Insurance
- Territory (includes inforce/premium by state)
- Plan of Operation
- Market Conduct Activities (includes privacy statement)
- Reinsurance
- Retirement Plan and Other Employee Benefits
- Loss Experience
- Accounts and Records
- Statutory Deposits
- Agreements with Parent, Subsidiaries and Affiliates
- Pecuniary Interest Tenn. Code Ann. § 56-3-103
- Commission Equity
- Dividends or Distributions
- Litigation
- Subsequent Events
- Financial Statement

The previous examination was conducted as of December 12, 2000 by authorized representatives of the Department of Commerce and Insurance, State of Tennessee and was the organizational examination for the Company. The last previous examination noted that the Company filed an amendment to the December 12, 2000 financial statement which resulted in a \$9,800 decrease in surplus due to a cash deposit of \$10,000 being made on December 19, 2000 rather than December 12, 2000. An additional bank account was confirmed during the examination which had a balance of \$200. The last previous examination additionally gave notice to the Company that upon licensure, disclosure and filing were required pursuant to Tenn. Code Ann. § 56-11 (Insurance Holding Company System Act of 1986) to which the Company subsequently complied. The Insurance Holding Company System Annual Registration Statement was signed and dated January 31, 2001.

## COMPANY HISTORY

The Company was incorporated on April 27, 2000 under the Tennessee Business Corporation Act as a for-profit corporation authorized to transact business in the State of Tennessee. The Company's Charter authorizes it to engage in and conduct insurance business of all types, except life and annuity. The first meeting of the incorporators was held on March 7, 2000. At that meeting, the Charter and the Corporate Bylaws were approved and the Board of Directors was elected. It was further "Resolved that the Board of Directors be and they are hereby authorized to issue the capital stock of the corporation to the full amount or the number of shares authorized by the Articles of Incorporation, in such amounts and proportions as from time to time shall be determined by the Board, and to accept in full or in part payment thereof such property as the Board may determine shall be good and sufficient consideration and necessary for the business of the corporation." At this same meeting, it was resolved that the Commissioner and Deputy Commissioner of "The Department of Commerce and Insurance" shall be considered and held as continuing power of attorney for said company, for the purpose of process in any action against it. The first meeting of the Board of Directors was held on March 8, 2000 at which time, officers were elected.

On April 28, 2000, Stock Certificate One for 550,000 shares of capital stock was issued to Jeffrey L. Kelley, Stock Certificate Two for 200,000 shares was issued to Clinton B. Haley, Stock Certificate Three for 200,000 shares was issued to Vincent G. Kelly, and Stock Certificate Four for 50,000 shares was issued to Danny W. Lazenby.

The Company was issued a certificate of authority dated January 16, 2001 from "The Department of Commerce and Insurance" of the State of Tennessee to transact the business of property; casualty; vehicle insurance. The Company's principal place of business is 216 South Cooper, Memphis, Tennessee.

On April 18, 2001, the Board of Directors approved an option for Charles L. Kelley, Sr. and/or Lennie F. Kelley to purchase all of the original stock issued to Vincent G. Kelley. Additionally, Charles L. Kelley, Sr. and/or Lennie Kelley were granted an option to purchase 30% of the original stock issued to Jeffrey L. Kelley which was approved by the Board at the same meeting.

On April 24, 2002, Charles L. Kelley, Sr. exercised the option to purchase all 200,000 shares of the capital stock owned by Vincent G. Kelley. Mr. Charles L. Kelley, Sr. subsequently filed a "Disclaimer of Control" dated May 1, 2003 with "The Department of Commerce and Insurance". The Disclaimer was received by "The Department of Commerce and Insurance" on May 21, 2003. No formal acceptance letter was issued to either Mr. Kelley or the Company.

At December 31, 2002, the Company was licensed in one state, Tennessee.

The following exhibit depicts certain aspects of the growth and financial history of the Company since the previous examination, according to annual statements filed with the Department of Commerce and Insurance, State of Tennessee.

<u>Date</u>	<u>Earned Premiums</u>	<u>Incurred Losses &amp; LAE</u>	<u>Admitted Assets</u>	<u>Liabilities</u>	<u>Capital and Surplus</u>
12/31/2000	\$0	\$0	\$2,328,499	\$0	\$2,328,499
12/31/2001	511,092	392,070	5,440,079	3,003,779	2,436,300
12/31/2002	1,044,965	957,191	6,272,748	3,711,288	2,561,460

### CHARTER AND BYLAWS

#### Charter:

The Charter was filed and recorded with the Tennessee Secretary of State on April 27, 2000, and recorded with the Shelby County Register on December 4, 2000. The Charter had been approved by "The Department of Commerce and Insurance" on April 27, 2000. The principal purposes of the Company are:

- (i) "To engage in any lawful business for which corporations may be incorporated pursuant to the laws of Tennessee;"
- (ii) "To engage in and conduct insurance business of all types, except life and annuity, including without limitation all activities under Tennessee insurance laws and regulations, to issue insurance policies, to make contracts of insurance; and to establish and hold reserves;"
- (iii) "The Corporation shall have all the powers incident to conducting its business as a corporation organized under Tennessee laws."

The Charter authorizes a maximum number of ten million (10,000,000) shares of capital common stock with a par value of one dollar (\$1) per share.

The corporation's existence is perpetual and its initial registered office is established at 3140 South Mendenhall Road, Memphis, TN. The name of the Corporation's initial registered agent at its registered office is Jeffrey L. Kelley.

#### Bylaws:

The Bylaws of the Company in effect at December 31, 2002 were adopted by the

unanimous consent of the Board on March 7, 2000 at the meeting of the Incorporators and have not been amended or changed during the period covered by this examination.

An annual meeting of the shareholders of the Company shall be held at such time and place, either within or without this State, as may be designated from time to time by the directors. Unless the time is otherwise specified, said meetings shall be held in June of each year, or as close thereto as practicable. Special meetings of the shareholders may be called by the president, a majority of the board of directors, or by the holders of at least thirty percent (30%) of the stock of the Corporation entitled to vote at such meeting. The place of special meetings shall be designated by the directors or stockholders calling said meeting. A majority of shares entitled to vote shall constitute a quorum for the transaction of business.

The business and affairs of the Corporation shall be managed under the direction of a board of directors. The number of directors shall be not less than two nor more than seven members. The annual meeting of the board of directors shall be held immediately after adjournment of the annual meeting of shareholders, at which time the officers of the corporation shall be elected. The board may also designate more frequent intervals for regular meetings. A majority of the directors shall constitute a quorum.

The officers for the corporation shall be a president and a secretary, and such other officers as the board of directors shall from time to time deem necessary. Any two or more offices may be held by the same person, except the offices of president and secretary.

The bylaws contain a restriction on transfer of shares of capital stock as follows: "The shares of stock may not be sold, transferred or assigned except as provided in the Corporation's Certificate of Incorporation, its bylaws, or agreement among shareholders or any amendments thereto."

## **MANAGEMENT AND CONTROL**

### **Management:**

The Company's bylaws state that the business and affairs of the Company shall be under the direction and control of a Board of Directors consisting of not less than two (2) or more than seven (7) directors. As of December 31, 2002, the Board of Directors of the Company was composed of the following:

Jeffrey Laine Kelley  
Vincent Gregory Kelley  
Clinton Boyce Haley

Danny Wayne Lazenby  
Charles Larry Kelley, Sr.

As of December 31, 2002, the following persons held office in the Company:

Jeffrey Laine Kelley, President  
Vincent Gregory Kelley, Secretary/Treasurer  
Clinton Boyce Haley, Vice President  
Danny Wayne Lazenby, Vice President  
Charles Larry Kelley, Sr., Vice President

The administrative and executive functions of the Company are performed by the home office staff. Marketing and other general agency services are performed by AutoPlan U.S.A., Inc. which is an affiliated company. Claims adjustment activities are performed by Corporate Insurance Services, Inc. which is an affiliated company. Relationships with the mentioned firms are discussed under the heading "Agreements with Parent, Subsidiaries and Affiliates". Certain services are purchased from outside contractors if needed and are not available from in house personnel. Such services include actuarial analysis and independent audit.

Actuarial Services: Actuarial / Insurance Consultants Ltd.  
381 Highway 20  
Loganville, GA 30052

Auditing Services: Lee R. Watson, CPA  
P. O. box 100512  
Nashville, TN 37205

**Control:**

The primary control of the Company is vested in its four (4) shareholders. The shareholders and their percentage of ownership are as follows:

Jeffrey L. Kelley (55%),  
Charles L. Kelley, Sr. (20%),  
Clinton B. Haley (20%)  
Danny W.Lazenby (5%).

A holding company organizational chart is included at the last page of this examination report.

The Company has not established a conflict of interest policy for its directors and officers to attest to compliance with Tenn. Code Ann. § 56-3-103.

## CORPORATE RECORDS

Minutes of meetings of the shareholders and Board of Directors of the Company were reviewed for the period under examination. In general, such minutes appear to be in proper order and accurately report the proceedings of each respective meeting.

### FIDELITY BOND AND OTHER INSURANCE

The following is a schedule of insurance maintained by the Company at December 31, 2002.

<u>Type of Coverage</u>	<u>Coverage Limits</u>
1. Business Account Package Policy	
A) Business Liability	
Liability and Medical Expense	\$1,000,000
Medical Expenses (per person)	\$10,000
Fire Legal Liability (any one fire)	\$100,000
Products/Completed Operations Aggregate	\$2,000,000
General Aggregate	\$2,000,000
Hired and Non-Owned Auto Liability (each occurrence)	\$1,000,000
B) Property and Miscellaneous Coverages	
*Policy Deductible \$500	
Property In Transit	\$15,000
Employee Dishonesty	\$10,000
Forgery And Alteration Coverage	\$10,000
Property Temporarily Off Premises	\$15,000
C) Various Property Coverages For Buildings	
Includes Agency Offices owned by AutoPlan USA, Inc.	

Coverage is underwritten by National Fire Insurance Company of Hartford which is licensed in Tennessee as a "Foreign Property and Casualty Insurer".

2. Workers' Compensation and Employers Liability	
A) Workers Compensation	Tennessee Limit
B) Employers Liability	
Bodily Injury by Accident (each accident)	\$100,000
Bodily Injury by Disease (policy limit)	\$500,000
Bodily Injury by Disease (each employee)	\$100,000

Coverage is underwritten by Travelers Casualty and Surety Company which is licensed in Tennessee as a "Foreign Property and Casualty

Insurer”.

Minimum fidelity bond coverage of \$125,000 to \$150,000 is suggested by guidelines published in the NAIC Financial Condition Examiners Handbook. Presently, the Company has \$10,000 employee dishonesty coverage and no directors and officers liability coverage.

### TERRITORY

As of December 31, 2002, and as of the date of this examination report, the Company was licensed to transact business in the State of Tennessee. The Certificate of Authority for that jurisdiction was reviewed.

During 2002, the Company wrote direct premium in one (1) state:

<u>State</u>	<u>Amount</u>
Tennessee	<u>\$5,969,890</u>
Total	\$5,969,890

### PLAN OF OPERATION

The Company writes personal automobile liability and physical damage coverage for the non standard market in Shelby, Tipton and Fayette Counties in Tennessee. All policies are issued on a twelve (12) month basis. Premiums are payable in monthly installments of 1/12 (8.33%) of annual premium plus a billing fee of ten dollars (\$10) per month. If premiums are paid before the monthly bill has been produced, the ten dollar (\$10) fee does not apply. The vast majority of the business is produced by a captive agency, AutoPlan U.S.A., Inc. One independent agency also writes policies on behalf of the Company. The Company is additionally approved to issue a Tenant Fire policy with a maximum coverage of \$15,000; however, less than five policies have been issued.

The automobile policies are basic limit coverage and excess limit coverage as follows:

Basic Limit Policies:

Private Passenger Automobile Liability:

\$25,000 Bodily Injury each person

\$50,000 Bodily Injury each accident

\$10,000 Property Damage each accident

Private Passenger Automobile Physical Damage  
\$50,000 each vehicle

Uninsured Motorists:  
\$25,000 Bodily Injury each person  
\$50,000 Bodily Injury each accident  
\$10,000 Property Damage each accident

Underinsured Motorists:  
\$25,000 Bodily Injury each person  
\$50,000 Bodily Injury each accident  
\$10,000 Property Damage each accident

Medical Payments:  
\$500 each person

Automobile Rental Reimbursement  
\$450

Excess Limits Policies:  
Private Passenger Automobile Liability  
\$100,000 Bodily Injury each person  
\$300,000 Bodily Injury each accident  
\$50,000 Property Damage each accident

Private Passenger Automobile Physical Damage  
\$50,000 each vehicle

Uninsured Motorists:  
\$100,000 Bodily Injury each person  
\$300,000 Bodily Injury each accident  
\$50,000 Property Damage

Underinsured Motorists:  
\$100,000 Bodily Injury each person  
\$300,000 Bodily Injury each accident  
\$50,000 Property Damage each accident

Medical Payments:  
\$500 each person

Automobile Rental Reimbursement  
\$450

The largest net amount insured by the Company in any one risk is \$17,500.

During the period under review and through the date of this report, all policy preparation was performed in the home office and was subject to the underwriting rules adopted by the Company and promulgated in accordance with approved rates. Premiums for new policies, policy endorsements and renewal amounts are collected by AutoPlan U.S.A., Inc. in a fiduciary capacity and remitted to the Company. Further overview is contained under the caption "Agreements with Parent, Subsidiaries and Affiliates". The Company and the agency are changing the collection process effective October 1, 2003 and premiums will be deposited directly into the Company's bank account.

The adjustment of claims is handled by Corporate Insurance Services, Inc. (CIS, Inc.) an affiliated claims adjustment service company. The Company and CIS, Inc. entered into a contract for services which pays CIS, Inc. a flat fee per claim and is further discussed under the caption, "Agreements with Parent, Subsidiaries and Affiliates".

### **MARKET CONDUCT ACTIVITIES**

In accordance with the policy of "The Department of Commerce and Insurance", State of Tennessee, a market conduct review was made of the Company as of December 31, 2002 in conjunction with this examination. The following items were addressed:

#### **Policy Forms, Rating and Underwriting:**

Under Tenn. Code Ann. § 56-5-305, rates, supplementary rate information, policy forms and endorsements will be filed with the Commissioner at least thirty 30 days before the proposed effective date. The Company filed its policy form and original rates for the automobile policy on December 13, 2000. Approval was granted by The Department of Commerce and Insurance on January 18, 2001. The Company applied for a rate increase on December 31, 2002 and was granted approval on January 6, 2003. On July 7, 2003, the Company applied to update its automobile policy form by referencing a "me too" filing with USAuto Insurance Company for their policy form TN-100. Approval was granted by "The Department of Commerce and Insurance" on July 21, 2003.

The Company submitted a "me too" filing for a tenant fire policy on November 28, 2001 which referenced an original filing on behalf of US Auto of Tennessee which had been approved by "The Department of Commerce and Insurance" on July 9, 2001. Approval was granted to the Company on December 10, 2001.

The Company uses casualty rates developed by a combination of Company experience and industry data. Policies written were reviewed to application files and underwriting standards. Written underwriting procedures and a rating guide are maintained and utilized.

### **Advertising:**

The advertising program consists of a Company website ([www.paicinsurance.com](http://www.paicinsurance.com)) and advertising carried out by AutoPlan U.S.A., Inc. (captive agency). AutoPlan advertises on television and radio as well as in the Yellow Pages. The advertising file was reviewed and appears to be in compliance with applicable statutes and regulations.

### **Claims Review:**

A sample of open and closed claim files reviewed during the examination indicated that claims were being paid in accordance with policy provisions and settlements were made promptly upon receipt of proper evidence of the Company's liability.

### **Policyholder Complaints:**

Inquiries made to the various policyholders' service offices indicated no regulatory concerns with the Company during the period under examination. No unusual practices or items warranting criticism of the Company were noted.

### **Privacy Policy:**

The Company has a written privacy statement that includes all affiliated companies and agents. It is supplied to its policyholders annually in compliance with Tenn. Comp. R. & Regs. Tit. Dep't of Commerce and Ins., ch. 0780-1-72.

## **REINSURANCE**

The Company's reinsurance agreements were reviewed and found to contain the standard provisions for arbitration, cancellation, errors and omissions, exclusions, insolvency, offset, settlement, taxes and termination. The following is a summary of the reinsurance agreements in effect as of December 31, 2002:

### **Ceded:**

(1)

<b><u>Type:</u></b>	Quota Share
<b><u>Reinsurer:</u></b>	Transatlantic Reinsurance Company
<b><u>Term:</u></b>	January 1, 2001 until terminated
<b><u>Premium:</u></b>	Proportional share of the Gross Written Premium Income less a provisional ceding commission of 26%
<b><u>Commission:</u></b>	A provisional ceding commission of 26.0% of the Gross Net Written Premium Income adjusted annually to a minimum ceding commission equal to 26.0% of the ceded Gross Net

Earned Premium Income at a Loss Ratio of 69.0% or higher. Adjustment of 1% for each decrease of 1% in Loss Ratio until a ceding commission of 27% is reached at a Loss Ratio of 68.0% or lower. Adjustment of .75% for each decrease of 1.0% in Loss Ratio until a maximum ceding commission of 35.25% is reached at a Loss Ratio of 57.0% or lower.

Coverage:

80% Quota Share participation of up to \$500,000 each Policy, each Loss Occurrence for Basic Limit Policies and a 95% Quota Share participation of up to \$500,000 each Policy, each Loss Occurrence for Excess Limit Policies, such amounts to include Loss Adjustment Expenses, Extra Contractual Obligations and Excess of Original Policy Limits losses.

For purposes of this Agreement:

- (a) Loss adjustment expenses shall not exceed 6.0% of the ceded Gross Net Earned Premium Income for each Agreement Year.
- (b) Extra Contractual Obligations and Excess of Original Policy Limits losses shall be subject to a maximum limit of liability to the Reinsurer \$1,500,000 for all losses occurring during each Agreement Year.

Intermediary:

Willis Re, Inc.

Transatlantic Reinsurance Company is a "Non-Licensed Accredited Property and Casualty Reinsurer" in Tennessee which qualifies as an authorized reinsurer. The contract does not require approval pursuant to Tenn. Code Ann.

## **RETIREMENT PLAN AND OTHER EMPLOYEE BENEFITS**

At December 31, 2002, the following benefits were available to the Company's employees:

401 (K) Plan

The Company offers a "Salary Reduction" plan to all employees. The Company matches dollar for dollar the first 3% and 50¢ on the dollar for the next 2%. The Plan is administered through Salomon Smith Barney and is a cafeteria plan with 12 to 15 different funds from which to allocate. The Company Match portion is 100% vested.

Medical Coverage

Medical coverage is provided through optional participation in UnitedHealthcare Choice Plus plan. The Company pays \$118 per month towards each employee's cost of healthcare.

Life Insurance, Long Term Disability, Etc.

Group rates are available on optional insurance coverage including Life, Short Term and Long Term Disability, Cancer and Accident Insurance through Allstate Insurance.

Education

The Company provides reimbursement to employees who take certain business and job related courses.

Other benefits available for employees include holidays, sick leave, and vacation leave.

**LOSS EXPERIENCE**

<u>Year</u>	<u>Losses Incurred</u>	<u>LAE Incurred</u>	<u>Premiums Earned</u>	<u>Loss Ratio</u>
2000	\$0	\$0	\$0	0.0%
2001	286,747	105,323	511,092	76.7%
2002	<u>521,791</u>	<u>435,400</u>	<u>1,044,965</u>	91.6%
Total	\$808,538	\$540,723	\$1,556,057	86.7%

**ACCOUNTS AND RECORDS**

During the course of examination, such tests and audit procedures were made as were considered necessary, including substantial verification of postings, extensions and footings and reconciliation of subsidiary ledgers to control accounts where necessary. General ledger trial balances were reconciled with copies of annual statements for the years 2001 and 2002.

Accounting records conform to generally accepted insurance accounting practices and appear to properly reflect the operations during the period under examination and the status of the Company at the date of examination.

The Company's Risk Based Capital Report was reviewed. The Company was in compliance with Tenn. Code Ann. § 56-46 (Risk Based Capital for Insurers).

An annual audit of the Company is performed by an independent accounting firm, Lee R. Watson, CPA.

Books and records of the Company are kept at the home office location:

216 South Cooper  
Memphis, TN 38104

### **STATUTORY DEPOSITS**

In compliance with statutory requirements, the Company maintained the following deposits at December 31, 2002.

<b><u>Where Deposited and Description</u></b>	<b><u>Par Value</u></b>	<b><u>Statement Value</u></b>	<b><u>Market Value</u></b>
<b>Tennessee</b>			
Knox County Gen Obligation Bond 4.45%	\$205,000	\$205,055	\$205,465
<b>Total general deposits held for the benefit of all policyholders of the Company</b>	<b><u>205,000</u></b>	<b><u>205,055</u></b>	<b><u>205,465</u></b>
<b>Total</b>	<b><u>\$205,000</u></b>	<b><u>\$205,055</u></b>	<b><u>\$205,465</u></b>

The above deposit was confirmed with the custodian at "The Division of Insurance".

### **AGREEMENTS WITH PARENT, SUBSIDIARIES AND AFFILIATES**

The Company is owned by 4 shareholders with the percentage of ownership as follows:

Jeffrey L. Kelley	55%
Clinton B. Haley	20%
Danny W. Lazenby	5%
Charles L. Kelley, Sr.	20%

This ownership makes the Company subject to Tenn. Code Ann. § 56-11 "Insurance Holding Company System Act of 1986". These same individuals own the same percentage of AutoPlan U.S.A. Inc. and Corporate Insurance Services, Inc. which have respective agency and claim administration agreements with the Company as follows:

(A) AutoPlan USA, Inc. has a general agency agreement with the Company

with effective date of January 1, 2001. This agreement allows the Agency to collect, receive and receipt for premiums in addition to all usual and customary services of an insurance agency concerning the insurance contracts placed by the Agency with the Insurer. AutoPlan receives a 19% commission for policies written plus 50% of the billing fees collected. The Company will also pay AutoPlan an additional compensation bonus which the reinsurer would pay to the Company as a result of the Loss Ratio being lower than the thresholds established in the reinsurance treaty with Transatlantic Reinsurance Company. The loss ratio thresholds are listed under the caption "Reinsurance" in this report. The bonus is contingent upon the Company meeting these targets. Premiums are collected by the agency on the Insurer's behalf and held in a fiduciary capacity. The premiums less the commission and fees due to the agency are remitted to the Company not later than 15 days after the end of the month in which the business written is entered on Insurer's books and records. Cost Sharing Arrangements between Agency and Insurer are based upon overhead expenses incurred by Agency that are applicable to Insurer at 15%. Termination can be effected by either party providing 90 days advance written notice.

The above referenced general agency agreement was filed with "The Division of Insurance" as a Form D filing dated October 19, 2001. Tenn. Code Ann. § 56-11-206(a)(2) requires that the Commissioner be notified in writing of the intent to enter into a transaction such as management agreements and service contracts thirty (30) days prior thereto. The transaction may be consummated unless "the commissioner has not disapproved it within such period". No formal disapproval was issued by "The Department of Commerce and Insurance".

- (B) Corporate Insurance Services, Inc. has a Contract for Services with the Company with an effective date of July 1, 2001 to provide claim administration services which include the following:

Basic claim service	Appraisals
Police reports	Independent Adjuster Services
History of vehicle registration/clear title guarantee	Claims research software
NADA Appraisal Information	Special Investigative Unit
Car tag registration	ISO Claims Search

The fee paid to Corporate Insurance Services, Inc. is \$350.00 per claim plus \$45.00 per hour for SIU work over 10 hours each claim.

Termination can be effected by either party providing 90 days advance written notice of its intent to terminate after the initial one-year period.

The above referenced contract for services was filed with "The Division of Insurance" as a Form D filing dated October 19, 2001. Tenn. Code Ann. §

56-11-206(a)(2) requires that the Commissioner be notified in writing of the intent to enter into a transaction such as management agreements and service contracts thirty (30) days prior thereto. The transaction may be consummated unless "the commissioner has not disapproved it within such period". No formal disapproval was issued by "The Department of Commerce and Insurance".

During 2002, AutoPlan U.S.A., Inc. and Corporate Insurance Services, Inc. were paid \$987,453 and \$308,700 respectively by the Company.

#### **PECUNIARY INTEREST TENN. CODE ANN. § 56-3-103**

During 2002, the four (4) stockholders only drew a salary from the Company. They received no salary from any of the other affiliated companies.

The Company has not established a conflict of interest policy for its directors and officers to attest to compliance with Tenn. Code Ann. § 56-3-103. The officers and directors do not file annual conflict of interest statements.

#### **COMMISSION EQUITY**

The ceded Quota Share Reinsurance agreement in effect at 12/31/2002 is on a gross written premium basis with a provisional ceding commission of 26%. This results in commission equity to the Company in the amount of \$644,619 based on the ceded unearned premium in the amount of \$2,479,304 at 12/31/2002. Commission equity is further discussed under the captions "Subsequent Events" and "Comments and Recommendations" in this report.

#### **DIVIDENDS OR DISTRIBUTIONS**

No dividends or distributions have been paid to stockholders since the inception of the Company.

#### **LITIGATION**

As of December 31, 2002, the Company had no pending litigation, other than that arising out of the normal course of business, which would adversely affect the financial condition of the Company.

## **SUBSEQUENT EVENTS**

Effective January 1, 2003, Granite LLC acquired the assets of AutoPlan, U.S.A., Inc. in order to convert to a limited liability corporation from a standard corporation for tax purposes. Granite LLC is owned in the same percentages by the same individuals that had owned AutoPlan. The full business name is Granite LLC dba AutoPlan USA, Inc. The new agency agreement with Granite was modified to have the agency receive a 15% commission on policies written and 100% of the billing fees collected per its filing with the department. Effective October 1, 2003, the agency began depositing the premiums collected into a bank account in the Company's name with Union Planters National Bank in compliance with a request from "The Department of Commerce and Insurance". The Granite LLC agency agreement was filed with "The Department of Commerce and Insurance" as a Form D Filing dated July 14, 2003. Tenn. Code Ann. § 56-11-206(a)(2) requires that the Commissioner be notified in writing of the intent to enter into a transaction such as management agreements and service contracts thirty (30) days prior thereto. The transaction may be consummated unless "the commissioner has not disapproved it within such period". No formal disapproval was issued by "The Department of Commerce and Insurance".

The Quota Share Reinsurance Agreement between the Company and Transatlantic Reinsurance Company was modified effective January 1, 2003 to have the provisional ceding commission paid on an earned basis rather than a written basis. This modification erased the commission equity during 2003 and subsequent years. As of September 30, 2003, less than \$21,502 of commission equity was left in ceded unearned premium for policies written during 2002.

The reinsurer additionally decreased its quota share participation to 75% from 80% for basic limit policies and to 85% from 95% for excess limit policies for the 2003 year effective with the new agreement.

## FINANCIAL STATEMENT

There follows a statement of assets, liabilities and statement of income at December 31, 2002, together with a reconciliation of capital and surplus for the period under review, as established by this examination:

### ASSETS

	<u>Ledger Assets</u>	<u>Non-Ledger Assets</u>	<u>Assets Not Admitted</u>	<u>Net Admitted Assets</u>
Bonds	\$205,055			\$205,055
Preferred Stocks	0			0
Common Stocks	642,982		34,780	608,202
Cash and short-term investments	1,675,162			1,675,162
Premiums and agents, balances in course of collection	0			0
Premiums, agent balances, and installments booked but deferred and not yet due	2,998,988			2,998,988
Reinsurance recoverables on loss and loss adjustment expenses	312,714			312,714
Federal and foreign income tax recoverable and interest thereon (including \$48,000 deferred tax asset)	69,000	18,338		87,338
Guaranty funds receivable or on deposit	0			0
Electronic data processing equipment and Software	0			0
Interest, dividends and real estate income Due and accrued	9,244			9,244
Receivable from parent, subsidiaries and Affiliates	359,604			359,604
Other non-admitted assets	0			0
Aggregate write-ins for other than invested Assets	<u>38,687</u>	_____	<u>38,688</u>	<u>(1)</u>
Totals	<u>\$6,311,436</u>	<u>\$18,338</u>	<u>\$73,468</u>	<u>\$6,256,306</u>

## LIABILITIES, SURPLUS, AND OTHER FUNDS

Losses	\$285,408
Reinsurance payable on paid loss and loss adjustment expenses	0
Loss adjustment expenses	167,661
Commissions payable, contingent commissions and other similar charges	0
Other expenses (excluding taxes, licenses and fees)	0
Taxes, licenses and fees (excluding federal and foreign income tax)	9,623
Federal and foreign income taxes	0
Unearned premiums	609,143
Advance premiums	0
Dividends declared and unpaid: policyholders	0
Ceded reinsurance premiums payable (net of ceding commissions)	2,679,816
Aggregate write-ins for liabilities (commission equity in ceded unearned premium)	<u>644,619</u>
Total Liabilities	4,396,270
Common capital stock	1,000,000
Gross paid in and contributed surplus	1,381,583
Unassigned funds (surplus)	<u>(521,547)</u>
Surplus as regards policyholders	1,860,036
Total liabilities and surplus	<u>\$6,256,306</u>

## STATEMENT OF INCOME

### UNDERWRITING INCOME

Premiums earned		\$1,044,965
Deductions: Losses incurred	\$572,791	
Loss expenses incurred	424,763	
Other underwriting expenses incurred	<u>280,477</u>	
Total underwriting deductions		<u>1,278,031</u>
Net underwriting gain		(233,066)

### INVESTMENT INCOME

Net investment income earned	103,761	
Net realized capital gains (losses)	<u>0</u>	
Net investment gain		103,761

### OTHER INCOME

Aggregate write-ins for miscellaneous income		<u>214,148</u>
Net income before dividends to policyholders and before federal income taxes		84,843
Dividends to policyholders		0
Federal income taxes incurred		<u>28,847</u>
Net income		<u>\$55,996</u>

CAPITAL AND SURPLUS

Surplus as regards policyholders, December 31 prior year		\$2,436,300
Net income	\$55,996	
Net unrealized capital gains (losses)	0	
Change in net deferred income tax	16,000	
Change in non-admitted assets	(3,641)	
Cumulative effect of changes in accounting principles	0	
Surplus adjustments: Paid in	0	
Aggregate write-in for gains and losses in surplus	(644,619)	
Change in surplus as regards policyholders for the year		(576,264)
Surplus as regards policyholders, December 31 current year		<u>\$1,860,036</u>

**RECONCILIATION OF CAPITAL AND SURPLUS  
FOR THE PERIOD UNDER EXAMINATION**

<b>Surplus as regards policyholders December 31</b>	<u><b>2000</b></u>	<u><b>2001</b></u>	<u><b>2002</b></u>
Previous Year	\$0	\$2,328,499	\$2,436,300
Net Income	0	124,544	55,996
Net unrealized capital gains or (losses)	0	0	0
Change in net deferred Income tax	0	0	16,000
Change in non-admitted Assets	0	(24,215)	(3,641)
Change in provision for Reinsurance	0	0	0
Cumulative effect of changes In accounting principles	0	0	0
Capital changes:			
Paid in	1,000,000		
Surplus adjustments:			
Paid in	1,374,111	7,472	0
Aggregate write-ins for gains and losses in surplus	<u>(45,612)</u>	<u>0</u>	<u>(644,619)</u>
<b>Surplus as regards to policyholders December 31 Current Year</b>	<u><b>\$2,328,499</b></u>	<u><b>\$2,436,300</b></u>	<u><b>\$1,860,036</b></u>

**ANALYSIS OF CHANGES IN FINANCIAL STATEMENT AND COMMENTS  
RESULTING FROM EXAMINATION**

<u>Item</u>	<u>Amount</u>
<b>Common stocks</b>	<b><u>\$608,202</u></b>

The above amount reflects an increase of \$608,202 to the amount stated in the annual statement. On December 31, 2002, the Company had on deposit in the sweep account with Trustmark Bank the amount of \$642,982. The Trustmark sweep is invested in "Performance Funds Trust" which is classified as common stock by the NAIC Securities Valuation office and is therefore limited to a total investment of 5% of admitted assets in shares of any one (1) institution pursuant to Tenn. Code Ann. § 56-3-402(4)(C)(i). This calculated to \$296,304. The basket clause limitation of 5% of admitted assets pursuant to Tenn. Code Ann. § 56-3-402(15) allowed the admission of an additional \$311,898. The remaining \$34,780 was non-admitted.

<b>Cash and short-term investments</b>	<b><u>\$1,675,162</u></b>
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The above amount reflects a reduction of \$642,982 from the amount stated in the annual statement. This is the amount on deposit in the sweep account with Trustmark Bank. Since the account sweeps its balances to "Performance Funds Trust" which is classified as common stock by the NAIC Securities Valuation Office, this amount was reclassified to line A-2.2, "Common stocks" for purposes of this examination to better comply with Statement of Statutory Accounting Principles No. 30 and annual statement instructions.

<b>Federal and foreign income tax recoverable and interest thereon</b>	<b><u>\$87,338</u></b>
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The above amount reflects an increase of \$39,338 from the amount stated in the annual statement. \$21,000 is a reclassification from line A-25, "Aggregate write-ins for other than invested assets" for refundable federal income tax to better comply with Statement of Statutory Accounting Principles No. 10 and annual statement instructions. \$18,338 is an increase for federal income tax refundable based on the adjustments to income for the various items listed under the caption "ANALYSIS OF CHANGES IN FINANCIAL STATEMENT AND COMMENTS RESULTING FROM EXAMINATION" which reduced federal income tax incurred by a corresponding \$18,338.

<b>Aggregate write-ins for other than invested assets</b>	<b><u>\$(1)</u></b>
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The above amount reflects a reduction of \$21,000 from the amount stated in the annual statement. The \$21,000 refundable federal income tax was reclassified to line A-15, "Federal and foreign income tax recoverable" to better comply with Statement of Statutory Accounting Principles No. 10 and annual statement

instructions.

**Losses** **\$285,408**

The above amount reflects an increase of \$51,000 from the amount stated in the annual statement. This amount is the adverse development of claim reserves and paid claims as exhibited by the Company's Quarterly Statement as of September 30, 2003 for the year 2002 and prior years.

**Ceded reinsurance premiums payable** **\$2,679,816**  
**(net of ceding commissions)**

The above amount reflects a decrease of \$10,637 from the amount stated in the annual statement which is the summation of two calculations included in treaty funds held. A math calculation which had not been posted to the general ledger increases the liability by \$7,715. The "treaty funds held" general ledger account is a roll forward of all the different components which make up settlement of the reinsurance account. The other side of the accounting entry is a debit to loss expenses incurred. During review of the roll forward and the CPA workpapers, it was additionally concluded that the Company made their ceding commission income calculation based on collected premium rather than earned premium. The Company should report an additional \$18,352 of commission income. This correction will require a credit (decrease) to loss expenses incurred on the income statement and is also part of the "treaty funds held" calculation reducing the liability for "treaty funds held" by \$18,352.

**Aggregate write-ins for liabilities** **\$644,619**

The above amount reflects an increase of \$644,619 from the amount stated in the annual statement. The adjustment is the amount of commission equity in the ceded unearned premium reserve. The ceded Quota Share Reinsurance agreement in effect at 12/31/2002 is on a gross written premium basis with a provisional ceding commission of 26%. This results in commission equity to the Company in the amount of \$644,619 based on the ceded unearned premium in the amount of \$2,479,304 at 12/31/2002.

**Unassigned funds (surplus)** **\$(521,547)**

The amount of this item is \$701,424 less than the amount reflected in the Company's annual statement. The decrease is the result of the changes in the above items.

**SUMMARY SCHEDULE FOR “ANALYSIS OF CHANGES  
IN FINANCIAL STATEMENT AND COMMENTS RESULTING FROM  
EXAMINATION” AS THEY AFFECT SURPLUS**

The following depicts the change in surplus as outlined in the previous section of this report:

<u>Item</u>	<u>Surplus</u>	
	<u>Increase</u>	<u>Decrease</u>
Common stocks	\$642,982	\$34,780
Cash and short-term investments		\$642,982
Federal and foreign income tax recoverable and interest thereon (including \$48,000 deferred tax asset)	39,338	
Aggregate write-ins for other than invested Assets		21,000
Losses		51,000
Ceded reinsurance premiums payable (net of ceding commissions)	10,637	
Aggregate write-ins for liabilities		644,619
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Totals	<u>\$692,957</u>	<u>\$1,394,381</u>
Net change in surplus		<u>\$701,424</u>

## COMMENTS AND RECOMMENDATIONS

### Comments:

- The Company negotiated with its commercial bank, Trustmark to have the excess funds on deposit swept to a Federated Treasury Sweep Account which qualifies as a cash equivalent asset as valued by the Securities Valuation Office of the NAIC in order that all funds on deposit with Trustmark will be classified as cash on future financial statements filed with "The Department of Commerce and Insurance". This change was effective as of December 23, 2003.
- The Company should allocate recoverable income tax to the asset, "Federal and foreign income tax recoverable" rather than an aggregate write in line on future filings with "The Department of Commerce and Insurance". This will better comply with Statement of Statutory Accounting Principles No. 10 and annual statement instructions.

### Recommendations:

- Tenn. Code Ann. § 56-11-206(a)(2) requires that the Commissioner be notified in writing of the intent to enter into a transaction such as management agreements and service contracts thirty (30) days prior thereto. The Company had filed its general agency agreement and claims service contract with "The Department of Commerce and Insurance" as Form D filings on October 19, 2001; however, filing did not fall into the above referenced time window. The Company was made aware of the requirement during the examination and stated that it will comply with future filings. The said agreements are outlined under the caption "AGREEMENTS WITH PARENT, SUBSIDIARIES AND AFFILIATES" on page 14 of this report.
- The Company was made aware that Tenn. Code Ann. § 56-3-103 prohibits pecuniary interest of directors and officers. It was suggested that the Company develop a conflict of interest policy and have the affected persons complete conflict of interest statements to attest compliance. The relationship of directors and officers of the Company to other companies in the holding company system is outlined under the captions "AGREEMENTS WITH PARENT, SUBSIDIARIES AND AFFILIATES" on page 14 of this report and "PECUNIARY INTEREST TENN. CODE ANN. § 56-3-103" on page 15 of this report.
- At December 31, 2002, the Company had surplus funds in the amount of \$860,036 after the establishment per examination of a liability for the "commission equity" in ceded unearned premium. This liability should be exhibited as an "Aggregate write-in for liability" on statements filed with

“The Department of Commerce and Insurance” and is discussed under the captions “COMMISSION EQUITY” on page 16 of this report and “ANALYSIS OF CHANGES IN FINANCIAL STATEMENT AND COMMENTS RESULTING FROM EXAMINATION” on page 24 of this report. The Company therefore does not exhibit “bona fide surplus funds” in the amount of \$1,000,000 required pursuant to Tenn. Code Ann. § 56-2-115. The Company does continue to comply with Tenn. Code Ann. § 56-46 (Risk-Based Capital for Insurers) and exceeds the minimum capital and surplus which would require “Company Action”.

The Company changed their reinsurance agreement effective January 1, 2003 to have the ceding commission paid on an earned basis which will alleviate the commission equity. The reinsurance agreement is further discussed under the caption “SUBSEQUENT EVENTS” on page 16 of this report. The commission equity based on ceded unearned premium at December 31, 2002 was \$644,619. As of September 30, 2003, less than \$21,502 of commission equity still existed. No commission equity remained by December 31, 2003. Had the reinsurance agreement been changed effective January 1, 2002, the Company would have exhibited \$1,504,655 in “bona fide surplus funds” as of December 31, 2002.

## CONCLUSION

Insurance examination practices and procedures, as promulgated by the National Association of Insurance Commissioners, have been followed in connection with the verification and valuation of assets and the determination of liabilities of Preferred Auto Insurance Company, Inc. of Memphis, Tennessee.

In such manner, it was determined that, as of December 31, 2002, the Company had admitted assets of \$6,256,306 and liabilities, exclusive of unassigned funds, of \$4,396,270. Thus, there existed for the additional protection of the policyholders, the amount of \$1,860,036 in the form of capital, gross paid in and contributed surplus and unassigned funds (surplus).

The \$860,036 in surplus does not meet the requirement for "bona fide surplus funds" in the amount of \$1,000,000 required pursuant to Tenn. Code Ann. § 56-2-115.

The Company subsequently changed its reinsurance agreement effective January 1, 2003 to have the ceding commission paid on an "earned" basis rather than a "written" basis which erases the commission equity liability during 2003. If this change had been effected as of January 1, 2002, the Company would have exhibited the amount of \$2,504,655 in the form of capital, gross paid in and contributed surplus and unassigned funds (surplus). These findings are detailed under the captions "SUBSEQUENT EVENTS" and "COMMENTS AND RECOMMENDATIONS" on pages 16 and 26 of this report.

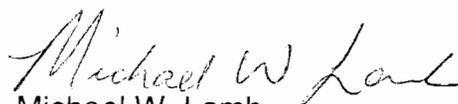
The change in the above styled reinsurance agreement subsequently produces compliance pursuant to Tenn. Code Ann. § 56-2-115.

The courteous cooperation of the officers and employees of the Company extended during the course of the examination is hereby acknowledged.

Respectfully submitted,



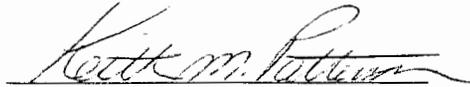
Keith M. Patterson  
Insurance Examiner  
State of Tennessee  
Southeastern Zone, N.A.I.C.



Michael W. Lamb  
Insurance Examiner  
State of Tennessee  
Southeastern Zone, N.A.I.C.

**AFFIDAVIT**

The undersigned deposes and says that he has duly executed the attached examination report of Preferred Auto Insurance Company, Inc. dated May 5, 2004, and made as of December 31, 2002, on behalf of "The Department of Commerce and Insurance", State of Tennessee. Deponent further says he is familiar with such instrument and the contents thereof, and that the facts therein set forth are true to the best of his knowledge, information and belief.



Keith M. Patterson  
Insurance Examiner  
State of Tennessee  
Southeastern Zone, N.A.I.C.

Subscribed and sworn to before me

this 5<sup>th</sup> day of  
May, 2004

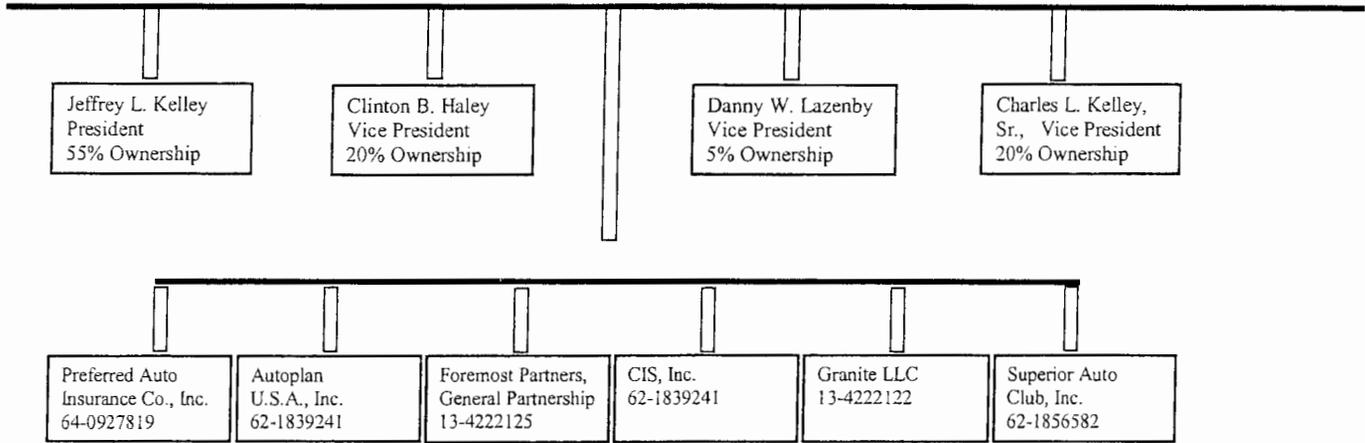
Notary Helen W. Darby

County Davidson

State Tennessee

Commission Expires 03/25/06

# ORGANIZATIONAL CHART



PREFERRED AUTO INSURANCE CO.

June 8, 2003

CERTIFIED MAIL

7003 2260 0003 4408 6081

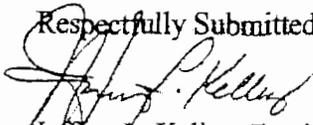
Mr. Don Spann, CFE  
Examinations Section  
State of Tennessee  
Dept. of Commerce and Insurance  
500 James Robertson Parkway  
Nashville, TN 37243-1135

Dear Mr. Spann:

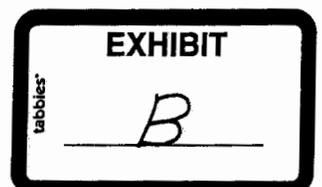
This letter is in response to your certified mail dated 5-10-04 concerning the financial condition exam results of Preferred Auto Insurance Company made as of December 31, 2002.

Please see the attached "EXHIBIT I" which represents our understanding of the change in Unassigned Surplus.

Respectfully Submitted,



Jeffrey L. Kelley, President  
Preferred Auto Insurance Company, Inc.



# PREFERRED AUTO INSURANCE CO.

EXHIBIT 1

June 8, 2004

In regards to your Report on Examination of our financial condition as of December 31, 2002, we would like to submit the following in response to your findings:

Page 16 of the report sets forth your finding that the Quota Share Reinsurance agreement in effect at December 31, 2002 is on a gross written premium basis with a provisional ceding commission of 26%. Accordingly, this resulted in commission equity on Ceded Unearned Premiums as of December 31, 2002 in the amount of \$644,619. Your proposal is that this overstatement arose from our recognition of ceding commission income during the calendar year 2002 on a written basis, instead of on an earned basis. Accordingly, it is your position that Preferred Auto Insurance Company, Inc. should have recorded a liability for commission equity and reduced Unassigned Surplus by the same \$644,619.

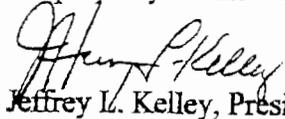
As set forth on Page 11 of your report, our Quota Share Agreement with the reinsurance company calls for a monthly provisional ceding commission of 26% of ceded Gross Net Written Premium reported to the reinsurer. Furthermore, as set forth in both your examination report and our Quota Share Agreement in effect for 2002, we settle annually with the reinsurer based on ceded Gross Net Earned premium.

This is effectively recognized through the net commission adjustment bonus, as calculated by the reinsurer based upon the Quota Share Agreement. Therefore, it is our position that at December 31, 2002 this commission was adjusted for this commission adjustment bonus, resulting in our provisional ceding commission being adjusted to the actual, based on **Net Earned Premiums**. This would result in no commission equity in ceded unearned premiums at December 31, 2002.

We recognize that in your "Comments and Recommendations" that the net of your findings is that there is no substantial problem, as the earned premium is resolved in the subsequent year. We also acknowledge that the examiner is not requesting that we amend the previously filed Annual Statement to reflect the overstated Surplus, which we appreciate.

However, we wanted to explain the detail of this issue to assure there is no misunderstanding with regards to the net equity of the Company.

Respectfully submitted,



Jeffrey L. Kelley, President

Preferred Auto Insurance Company, Inc.